Supreme Court, U.S.
FILED
DEC 11 1989
JOSEPH F. SPANIOL, JR.
CLERK

No. 89-569

(2)

In the Supreme Court of the United States

OCTOBER TERM, 1989

HOODKROFT CONVALESCENT CENTER, INC., ET AL.,
PETITIONERS

v.

STATE OF NEW HAMPSHIRE, DIVISION OF HUMAN SERVICES,
ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE FEDERAL RESPONDENT IN OPPOSITION

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15 pp

QUESTION PRESENTED

Whether a New Hampshire regulation that allows Medicaid providers to recover depreciation as part of the cost of providing medical services, but then requires the provider to return such reimbursements if the property is sold at a profit, provides "reasonable and adequate" reimbursement of "the costs which must be incurred by efficiently and economically operated facilities" under the Medicaid statute.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-15a) is reported at 879 F.2d 968. The opinion of the district court (Pet. App. 16a-26a) is reported at 701 F. Supp. 17.

JURISDICTION

The judgment of the court of appeals was entered on July 14, 1989. The petition for a writ of certiorari was filed on October 10, 1989. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. In accordance with the terms of the Medicaid program, the State of New Hampshire reimburses nursing

homes for Medicaid-related costs, including depreciation of buildings and equipment. This case involves a challenge brought by petitioners Hoodkroft Convalescent Center, Inc. (Hoodkroft) and its sole shareholder to New Hampshire's rules governing reimbursement for depreciation costs in connection with the provision of Medicaid services. These rules provide that the State will adjust depreciation reimbursement when a provider disposes of depreciated property. If the provider receives more for the property than its depreciated value, the State will recapture the excess depreciation reimbursement the provider has received.

a. Like other States and like the federal government in the Medicare program, New Hampshire treats depreciation of buildings and equipment as an allowable cost of providing care. Pet. App. 32a-34a; cf. 42 C.F.R. 405.415(a) (1985) (now codified at 42 C.F.R. 413.415(a)). Like the federal government, New Hampshire calculates depreciation according to a standard accounting method, dividing an asset's purchase price less estimated salvage value by its estimated useful life and reimbursing the facility for the annual depreciation derived thereby. See Pet. App. 34a; cf. *Richey Manor, Inc.* v. *Schweiker*, 684 F.2d 130, 135 (D.C. Cir. 1982) (same method of calculating depreciation under 42 C.F.R. 405.415 (1985)).

The New Hampshire regulations do not themselves expressly provide for calculation of depreciation recapture if a depreciated asset is sold at a gain. However, the New Hampshire regulations do provide that "[t]he extent to which any such reimbursement is recaptured is calculated based on" federal rules governing the Medicare—not the Medicaid—program. See Pet. App. 34a. According to these rules, if the sale price exceeds the depreciated cost of the asset, the difference between the two amounts is excess

depreciation. The State in these circumstances seeks to recapture the excess depreciation it has paid to the provider. See Pet. App. 34a; 42 C.F.R. 413.415(f)(1).

b. In 1974, Hoodkroft purchased a building and nursing equipment for approximately $1 million. Pet. App. 4a. Over time, New Hampshire paid Hoodkroft $173,000 for depreciation. *Ibid.* In 1985 Hoodkroft sold the building and equipment for $3 million, thus realizing a profit of approximately $2,000,000. *Ibid.* Because the property had thus increased in value under the New Hampshire regulations, New Hampshire sought to recapture the $173,000 in depreciation costs it had previously paid Hoodkroft. *Ibid.* Hoodkroft pursued a state administrative appeal of the determination that it had to repay the $173,000. The state administrative agency stayed the appeal to permit judicial review of the rules. Pet. App. 17a.

2. Hoodkroft then filed this action in state court alleging that the State's attempt to recapture the depreciation payments contravened the Medicaid statute's mandate that participating States reimburse the reasonable costs incurred by such facilities. See 42 U.S.C. 1396a(a)(13)(A). After New Hampshire removed the action to federal district court pursuant to 28 U.S.C. 1441 and successfully moved to join the Secretary of Health and Human Services (the Secretary) as a party-defendant, the parties filed cross-motions for summary judgment. The district court granted summary judgment in favor of New Hampshire and the Secretary (Pet. App. 16a-26a), concluding that the calculation of depreciation by New Hampshire was reasonable and consistent with a 1984 amendment to the Medicare Act. Pet. App. 20a-21a.

3. The district court's decision was affirmed by the First Circuit on appeal. Pet. App. 1a-15a. The New Hampshire

rule uses the difference between the historical cost in dollars of a facility and the selling price of that facility in dollars to determine the amount of depreciation that the facility actually underwent. The court noted that the dispute essentially centered on petitioners' contention that "the state must interpret its recapture rule so as to exempt, on a case-by-case basis, gains that are proven to reflect only inflation, rather than a lack of actual wear and tear." Pet. App. 9a. The court rejected this contention, holding that the State's rules "represent a reasonable, and therefore lawful, interpretation of the Medicaid statute." *Ibid.* The court cited five reasons in support of this conclusion.

First, the court of appeals recognized that "[t]he statute, explicitly, and relevant principles of administrative law, implicitly, give to the State and the Secretary broad legal power to determine" what constitutes reasonable and adequate reimbursement for providers. Pet. App. 9a. This conclusion was buttressed by an amendment to the Medicare statute that mandated use of the precise depreciation recapture policy used by the State in connection with its Medicaid program, and that thus provides inferential support for the proposition that the State rule at issue here was "consistent with the purposes of the Medicaid statute." Pet. App. 10a.

Second, the court of appeals noted that the "the law can, and often does, use the concept of 'depreciation costs' to refer not to a physical fact (*e.g.*, that a piece of equipment is worn), nor to an economic fact (*e.g.*, that wear and tear makes it less valuable than a new piece of equipment), but rather to an accounting fact, namely, a certain percentage of the nominal, historical price paid for the item." Pet. App. 10a. This approach, which simply promises "that an investor will eventually receive back the historical, nominal dollars that he invested in an asset" (Pet. App. 11a), is a reasonable approach to dealing with decline in value of assets over

time, and is familiar from a number of legal contexts, including the Internal Revenue Code. *Ibid.*

Third, this concept of depreciation is customarily employed in the directly analogous context of state regulation of public utilities. Utilities are generally allowed a reasonable dollar profit based on their investment, as measured by historical, nominal dollar costs not adjusted for inflation. When a utility sells a facility at a gain, ratepayers – not the utility itself – are entitled to recapture previous allowances for depreciation that the utility has taken. Pet. App. 12a. The same conclusion of reasonableness that attaches to this rule when used in the public utility context should apply in the context of Medicaid reimbursement as presented in this case. Pet. App. 13a, citing cases.

Fourth, an important advantage of the use of historical, nominal dollars to calculate depreciation is administrative efficiency. As the court stated, "[t]o try to measure the current value of a facility each year; to try to assess the actual yearly economic losses caused by equipment wear and tear; to try to determine the extent to which any gain on resale reflects (a) less than-expected wear and tear, (b) inflation, or (c) special market factors such as shortages, all would pose formidable administrative difficulties." Pet. App. 14a.[1]

Finally, the court noted that because providers like Hoodkroft were on notice of New Hampshire's treatment of depreciation and its recapture rules, there was no

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[1] The court noted that the well-known attack by Justices Brandeis and Holmes on the "fair value" ratemaking rule of *Smyth* v. *Ames*, 169 U.S. 466 (1898), convincingly described the difficulties of making determinations analogous to those that would be required by petitioners' position in this case. See *Missouri* v. *Public Serv. Comm'n*, 262 U.S. 276, 289-312 (1923) (Brandeis and Holmes, JJ., dissenting). See *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944) (rejecting "fair value" approach on similar grounds).

unfairness in applying those rules to petitioners. Pet. App. 14a-15a.

ARGUMENT

The decision of the court of appeals is correct and is consistent with decisions of the Seventh Circuit and the Court of Claims that have addressed the legality of the federal Medicare rule on which the challenged New Hampshire rule is patterned, and have upheld that rule against arguments like those urged by petitioners here. See *Stewards Found.* v. *United States*, 654 F.2d 28 (Ct. Cl. 1981); *Professional Medical Care Home, Inc.* v. *Harris*, 644 F.2d 589, 592 (7th Cir. 1980). Although the Eleventh Circuit has reached a contrary conclusion concerning the federal Medicare rule, see *Mercy Community Hospital* v. *Heckler*, 781 F.2d 1552 (11th Cir. 1986), that decision was reached without the benefit of briefing or argument concerning a statute requiring the government to use precisely the method of calculating depreciation recapture at issue in this case, and thus does not necessarily represent a conflict with the conclusion reached by the First Circuit in this case. Further review by this Court is therefore not warranted.

1. Petitioners contend that, notwithstanding the fact that they sold their facility for $2 million more than they paid for it, the facility nonetheless suffered a decrease in value during the time that they held it. This diminution in value, according to petitioners, was a "cost" that they "incurred," but, according to petitioners, it was masked by the effects of inflation or other "market factors" that made their property more valuable. Thus, by recapturing the depreciation payments that they had previously received, the State was allegedly setting rates in contravention of the statutory standard, which requires "rates * * * reasonable and adequate to meet the costs which must be incurred by efficiently

and economically operated facilities." 42 U.S.C. 1396a(a)(13)(A).

For the reasons given by the court of appeals, New Hampshire reasonably refuses in this context to recognize as "costs" alleged losses in value of a property that do not – because of inflation or "market factors" – result in a loss measured in dollars to the provider. Even if the statutory standard were far more rigorous than the broad "reasonable and adequate" statutory standard on which petitioners purport to rely, the New Hampshire rule would provide a permissible method – albeit perhaps not the only one – for calculating depreciation upon sale of a property. The state rule simply adapts for use in the Medicaid program a standard method for calculating depreciation familiar from the federal Medicare program and the Internal Revenue Code. Perhaps most analogous to the circumstances here, the method is commonly used in state regulation of public utilities, where – as here – the goal is to permit the regulated entity to obtain reimbursement for its costs through "reasonable" rates. See cases cited at Pet. App. 12a-13a.

The broad discretion afforded to the States and the Secretary in administering the Medicaid program provides further support for the challenged rule. As this Court held in *Chevron U.S.A. Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837, 844 (1984), "considerable weight should be accorded to an [agency's] construction of a statutory scheme it is entrusted to administer." In this case, New Hampshire decided to adopt a commonly used method for determining depreciation – and thus for defining terms such as "costs" and "reasonable and adequate" in the governing legislation. Petitioners do not address or distinguish the numerous cases holding that an agency's decision to adopt a particular construction – even where other constructions were possible and would have been preferred by a

regulated entity—is entitled to substantial deference. *E.g.*, *Atkins* v. *Rivera*, 477 U.S. 154, 162 (1986); *United States* v. *Riverside Bayview Homes*, 474 U.S. 121, 131 (1985); *Chemical Mfrs. Ass'n* v. *Natural Resources Defense Council*, 470 U.S. 116, 125 (1985).

Finally, petitioners attack reliance by the court of appeals on "administrative inconvenience" as a "familiar hobgoblin" that can be easily avoided "by placing on the provider the burden of showing what portion of the gain on sale resulted from inflation or market factors." Pet. 17. Yet, as the court of appeals recognized (Pet. App. 14a), petitioners' suggested inquiry into whether an apparent gain was simply the result of inflation would require the state agency to make extremely difficult determinations as to appropriate measures of inflation in a local community over a particular period of time. In addition, petitioners' suggested inquiry into the presence of "market factors" that allegedly account for a gain would require the state administrative agency to grapple with many extremely complex and controversial issues, such as the definition of the appropriate market for the services involved, the demand for medical services of particular types in that market, changes in the capacity of various institutions in the market to provide such services, the existence of barriers to entry in the market, and the like. Nothing in the statute requires that the State undertake an inquiry of this type, when alternative and widely-accepted methods of accounting for depreciation, such as the method adopted by the State in this case, are available.

2. As petitioners point out, the Eleventh Circuit in *Mercy Community Hospital* v. *Heckler*, 781 F.2d 1552 (1986), adopted a conflicting view of the treatment of depreciation recapture in the federal Medicare program. However, because the Eleventh Circuit decision involved sale of a facility in 1978, the court did not have the occasion to take into account a subsequently enacted statute that

mandates the result reached by the First Circuit in this case. Thus, it cannot be concluded that there is a genuine conflict in the circuits at this time.[2]

Prior to the amendment, the Medicare statute had provided that the Secretary shall determine the "reasonable cost" of services "in accordance with regulations establishing the method or methods to be used." 42 U.S.C. 1395x(v)(1)(A). In 1984, Congress enacted an amendment adding that "[s]uch regulations shall provide for recapture of depreciation in the same manner as provided under the regulations in effect on June 1, 1984." 42 U.S.C. 1395x(v)(1)(O)(ii) (Supp. IV 1986).[3] At the time of the amendment, the

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[2] Although the New Hampshire Medicaid scheme adopts the federal Medicare regulation that is the sucessor to the regulation at issue in *Mercy Community Hospital*, it should also be noted that the legal validity of the New Hampshire Medicaid regulation is governed by a somewhat different statutory standard. The Medicare statute at issue in *Mercy Community Hospital*, required that Medicare providers be reimbursed for the lesser of their charges or reasonable costs. 42 U.S.C. 1395f(b). The term "reasonable cost" was defined as "the cost actually incurred, excluding therefrom any part of incurred cost found to be unnecessary in the efficient delivery of needed health services." 42 U.S.C. 1395x(v)(1)(A). In turn, the Secretary was directed to promulgate regulations governing the "methods to be used" in determining reasonable costs, and these regulations were specifically required to "take into account both direct and indirect costs of providers." *Ibid.* See *Mercy Community Hospital*, 781 F.2d at 1553.

In contrast to the more articulated statutory scheme at issue in *Mercy Community Hospital*, with its specific direction that "direct and indirect costs" must be taken into account, the Medicaid statute simply requires that regulations be adopted that provide for "reasonable and adequate" reimbursement. Thus, the federal Medicare rules and the New Hampshire Medicaid rule at issue here, while similar in substance, address different regulatory programs and their legal validity must be judged under somewhat different statutory standards.

[3] The conference committee report explained the new language as specifying that the "Secretary would be required to continue recapture

then-current regulations and policy provided for depreciation recapture in Medicare cases in precisely the same manner followed by New Hampshire in this case, as attested by the decisions predating the statutory change and upholding the policy. See *Stewards Found.* v. *United States*, 654 F.2d 28 (Ct. Cl. 1981); *Professional Medical Care Home, Inc.* v. *Harris*, 644 F.2d 589, 592 (7th Cir. 1980). Thus, the amendment effectively gives explicit congressional sanction to the depreciation recapture policy at issue here.[4]

Given the facts of the case before it, the Eleventh Circuit in *Mercy Community Hospital* did not have the occasion to consider the 1984 amendment to the Medicare statute. Yet in this case, both the district court (see Pet. App. 20a-21a) and the court of appeals (see Pet. App. 10a) relied in part upon the 1984 amendment to reach their result. Therefore, it would be premature to conclude that the Eleventh Circuit would adhere to its decision in *Mercy Community Hospital* in a case involving a sale after the 1984 amendment. Accordingly, there is no genuine split in the circuits at this time that would warrant review in this Court.

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of the depreciation as under current reimbursement policy." H. R. Rep. No. 861, 98th Cong., 2d Sess. 1338 (1984).

[4] This amendment was first brought to the attention of the Eleventh Circuit in the government's petition for rehearing. The government argued that the statute should be read to provide congressional ratification of the challenged regulation. The Eleventh Circuit simply denied rehearing without comment in an unpublished order.

CONCLUSION

The petition for writ of certiorari should be denied.
Respectfully submitted.

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DECEMBER 1989

☆ U.S. GOVERNMENT PRINTING OFFICE 1989—262 203/00640